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BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF BLACK MOUNTAIN SEWER CORPORATION, AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES FOR UTILITY SERVICE BASED THEREON.	DOCKET NO: SW-02361A-05-0657

BLACK MOUNTAIN SEWER CORPORATION'S EXCEPTIONS TO RECOMMENDED OPINION AND ORDER

Arizona Corporation Commission
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Pursuant to A.A.C. R14-3-110(B), Black Mountain Sewer Corporation ("BMSC" or the "Company") submit these Exceptions to the Recommended Opinion and Order ("ROO") dated November 6, 2006.

SUMMARY

- **Affiliated Transactions:** The ROO adopts Staff's prohibition against profit earned by affiliates on transactions with public service corporations. BMSC submits that this is not an appropriate ratemaking standard. The Commission should consider the reasonableness of the total costs of all transactions in light of all of the available evidence, not just evidence of common ownership. In this case, the evidence shows that the operations and management of BMSC provided by affiliated entities are "very economically efficient".

- **Cost of Equity:** The Commission has consistently accepted Staff's recommended return on equity in water and sewer utility rate cases resulting in a downward trend in returns for the last few years. Now, key economic factors have changed significantly (moving in the opposite direction), yet Staff's recommendations have not. The result is the ROO's adoption of Staff's recommended return on equity, a return that is out of touch with current economic and market conditions and a disincentive to proactive plant investment.

- **Odor Issues:** Without conceding any legal challenges to the Commission's authority, BMSC accepts the requirement that it remedy the "Boulders odor problem". However, the Company requests certain changes to the ROO in an effort to ensure that the most prudent remedy is implemented and that unnecessary future proceedings before the agency are eliminated if the parties can work together cooperatively.

- **Effective Date of New Rates:** Rates should be effective December 1, 2006, or as soon as refunds of hook up fees are made to customers. Requirements that Staff approve the form of notice and review evidence of refunds are reasonable, but such review does not require a stay of the new rates.

BMSC'S EXCEPTIONS

A. Affiliated Transactions

The ROO correctly describes the Algonquin organizational model as different than the traditional model employed by Commission-regulated utilities, although there is some evidence that it is not "unique" in Arizona. *Compare* ROO at 12 *with* TR at 172-173

(Bourassa).[1] Under this model, affiliates of BMSC, primarily Algonquin Water Services, manage and operate the Company as well as 16 other water and sewer utilities in the United States, including 6 other water and sewer providers in Arizona. ROO at 12-13. This results in substantial economies of scale allowing the utilities to deliver a broader range of services at a lower cost. *See, e.g.,* TR at 169, 176 (Bourassa); 464-465, TR at 475-77 (Dodds). Staff characterized the Company as having "a very economically efficient operation and management." TR at 779 (Brown). Earlier this year, the Commission approved the Algonquin business model as the right choice to fix the McLain mess down in southern Arizona. *See* Decision No. 68826 (June 29, 2006).

In this setting, the ROO's harsh criticism is unwarranted. BMSC is not asking this Commission to "countenance a corporate shell game". ROO at 17. In a shell game, the goal is to hide the pea from discovery. Here, BMSC has shown the pea, such as the 4.5% profit earned by affiliates in transactions that are included in operating expenses.[2] Nothing material was hidden from the parties or the Commission with respect to these transactions and there is no evidence of fraud or injustice. BMSC simply asks that the Commission consider the reasonableness of the total cost of the transactions in light of the evidence, including evidence of the substantial benefits realized by BMSC and its ratepayers. Instead, the ROO declares profit on transactions between affiliates "inherently unreasonable." ROO at 17-18. This is not proper ratemaking.

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[1] Citations to the record are made as follows: Citations to a witness' pre-filed testimony are abbreviated using abbreviations DT, RB, SB or RJ as appropriate, along with the applicable exhibit numbers. Other hearing exhibits are cited by the hearing exhibit number and, where applicable, by page number, e.g., A-15 at 2. The hearing transcript is cited by page number, e.g., TR at 1, followed by the name of the testifying witness.

[2] Staff removed $21,761 from $480,192 of affiliate transactions included in the Company's operating expenses. Bourassa RB (Ex. A-2) *citing* Brown DT at 27 (Ex. S-9) and Schedule CSB-15, line 21. Staff's adjustment to rate base removed $20,926 on total projected costs of $258,863, a profit of roughly 8%. Bourassa RB (Ex. A-2) at 17.

A public service corporation's dealings with affiliates "require thorough investigation and close scrutiny." *See Turpen v. Oklahoma Corporation Commission*, 769 P.2d 1309, 1320 (Okla. 1989). *See also* Bourassa RB (Ex. A-5) at 9. The utility seeking to recover costs incurred in transactions with affiliates bears the burden of demonstrating that its transaction costs (including any profit) were reasonable. *Id.* at 1320-21. By itself, however, common ownership is not a ground for disallowing costs incurred with affiliates. *Id.* at 1321.

In this case, BMSC presented evidence showing that the total costs of the affiliated transactions were reasonable. The Company's witnesses explained how the business model resulted in economies of scale and better service. The evidence included cost comparisons to another management company and another utility, and estimated cost savings compared to the more traditional model. ROO at 16; Bourassa RB (Ex. A-2) at 35. The Company also presented testimony regarding market rates and the cost savings of affiliates that are passed on to ratepayers. TR at 474 (Dodds). RUCO did not find any evidence that the total costs were unreasonable and made no adjustment to the costs of affiliated transactions. ROO at 17; TR at 543 (Rigsby).

Once BMSC made an affirmative showing that its costs were reasonable, the burden shifted to Staff, as the party recommending adjustment, to provide "evidence showing why the payments to affiliates were not reasonable and should not be allowed." *Turpen* at 1323. *See also Central Louisiana Electric Co. v. Louisiana Public Service Comm'n*, 373 So.2d 123 at 127 (Before the regulatory body can make adjustments for unreasonably high charges "there must be . . . a factual finding, or at least a reasonable inference, that the charges are unreasonable."). But Staff did not do an analysis of the reasonableness of the total cost of the affiliated transactions. Staff proposed a simple rule—no profit for affiliates. Staff readily admitted that it would not have removed the small amounts of profit if the same transactions took place between unaffiliated entities.

See, e.g., TR at 777 (Brown). The ROO adopts this discriminatory black-letter rule.

BMSC accepts that the Commission may conclude that an adjustment to the total cost of affiliated transactions is warranted in this or any other rate case, but it is not appropriate to prejudge and prohibit all such transactions based solely on common ownership. Every public service corporation has the right to have its transactions viewed for reasonableness. If the evidence supports a finding that the total cost of transactions with affiliates is reasonable in light of the benefits to customers, the total cost should be recovered. *See Turpen*, 769 P.2d at 1321. This should be the result in this rate case.

B. <u>Cost of Equity</u>

The ROO correctly states that determining the cost of equity involves both art and science, and correctly concludes that "there is no clear-cut answer as to which formula should be used for reaching the appropriate outcome." ROO at 20. Yet, it certainly appears that the Commission has a clear-cut formula for setting the return on equity ("ROE") for water and sewer utilities—the Commission simply accepts the results of Staff's DCF and CAPM models without critical evaluation of the evidence presented. *See, e.g., Arizona Water Company-Eastern Group*, Decision No. 66849 (March 22, 2004) at 24 (approving 9.2% ROE), *Arizona-American Water Company*, Decision No. 67093 (June 30, 2004) at 31 (approving 9.0% ROE); *Chaparral City Water Company*, Decision No. 68176 (September 30, 2005) at 25 (approving 9.3% ROE); *Arizona Water Company-Western Group,* Decision No. 68302 (November 14, 2005) at 31 (approving 9.0% ROE). In each of these cases, all other evidence regarding the cost of equity was flatly rejected in favor of Staff's methodology and the results produced.

Staff uses the same cost of capital methodology from rate case to rate case. *See, e.g.,* TR at 684 (Chavez); Ex. A-21.. This case was the first time Staff's cost of capital witness, Pedro Chavez, had conducted a cost of capital analysis in a rate case. TR at 681-682 (Chavez). As the latest cost of capital witness, Mr. Chavez was given the resources, including the computer models he needed to use Staff's DCF and CAPM models. *Id.* By plugging the witness into the model, Staff's method has kept Staff's ROEs remarkably consistent over the past few years, as the decisions cited above illustrate. However, Staff's ROEs have not kept track with the economy.

The cost of equity moves with interest rates. *See* TR at 684 (Chavez). As a consequence, the lower ROEs authorized by the Commission for water and sewer utilities results have often been justified by reference to the lower than average interest rates prevalent in the early 2000s. *See, e.g.*, Exhibit A-21. But interest rates have increased significantly since those notable lows. *See, e.g.,* TR at 582-83 (Rigsby); 685 (Chavez). In fact, the Federal Reserve has raised the federal funds rate by a quarter point 16 times since June 2004. Bourassa RJ (Ex. A-3) at 26. Betas, which Staff uses in its CAPM model to measure investment risk have also increased significantly in that same general time period. TR at 711 (Chavez). Like interest rates, higher Betas lead to higher returns. TR at 702 (Chavez). Yet, by relying exclusively on Staff's recommended equity returns, the Commission's authorized ROEs remain out of touch with the changing economy and market conditions. There are several reasons for this phenomenon.

For one thing, Staff views BMSC, a small sewer provider under Commission regulation as less risky than giant utilities like Aqua America and American States, companies operating outside Arizona with billions of dollars of assets and revenues. *See* Bourassa DT (Ex. A-1) at 25-28; Bourassa RB (Ex. A-2) at 46-47. This is obviously contrary to realistic investor expectations. Furthermore, Staff's recommended ROEs (unadjusted for financial risk) have not moved in the same direction of interest rates and Betas as financial theory states. *See, e.g.,* Bourassa RJ (Ex. A-3) at 26. This leads to a lower ROE than would otherwise be expected given material changes in the economy and market conditions. This leads to the ultimate problem with Staff's methodology — the results are mechanically applied without due regard to economic reality and market conditions. *See, e.g.*, Bourassa RB (Ex. A-2) at 56-57. As a result, returns on equity for Arizona's water and sewer utilities have remained low contrary to changing economic conditions and out of touch with alternative investment opportunities.

At a time when significant capital investment is needed of providers like BMSC, returns on equity should encourage investment. The Company's recommended return of 11.0% does so. BMSC's methodology considers most, if not all, of the factors considered by Staff and RUCO; however, the Company's witness further considered the results of his DCF model in light of the prevailing economic factors and the unique risks, including regulation of small water and sewer utilities regulated by the Commission. Bourassa RB (Ex. A-2) at 47-48. As a result, BMSC's recommended ROE is sufficient to allow the utility to attract capital on reasonable terms, and is commensurate with returns on investments in other enterprises having corresponding risks. As such, it meets the well-established legal criteria for fair and equitable returns. *See Bluefield Water Works & Improvement Co. v. Public Serv. Comm'n of West Virginia*, 262 U.S. 679, 692-93 (1923); *Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944); *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 314-15 (1989).

C. <u>Odor Issues</u>

Maricopa County Environmental Services Department is responsible for enforcing the applicable odor control standards in Maricopa County and BMSC is not and has not been in violation of any such regulation. *See* Scott DT (Ex. S-1) at Exhibit MSJ. *See also* TR at 620 (Scott) (regarding MCESD authority). In fact, following a number of recent odor and noise related improvements, measured levels of noise and odors from BMSC's system were well below the maximum allowable standards. *See, e.g.,* Ex. A-14. Moreover, BMSC is in full compliance with all applicable regulations governing its operations. *See, e.g.,* Scott DT (Ex. S-1), Exhibit MSJ at 4; TR at 480 (Dodds). Nevertheless, BMSC agrees to remedy the "Boulders odor problem".

BMSC does so, not because it concedes that the Commission has authority to order such improvements, but because BMSC "would rather have happy customers." TR at 469-470 (Dodds). However, BMSC submits that certain changes to the ROO are needed to ensure that the remedy selected effectively resolves the concerns expressed by customers at the most reasonable cost. The Town's witness recommended two possible remedies to the "Boulders odor problem", however, Mr. Francom is not an engineer and the ROO recognizes that an alternative remedy might be more appropriate. ROO at 37, n. 13. The ROO also recognizes that 180 days may be inadequate to allow such remedy to be implemented. ROO at 37.

BMSC has already commissioned an engineering analysis (by the same unaffiliated third party engineering firm hired to evaluate the removal of the CIE Lift Station that is already underway) to determine the best remedy for the "Boulders odor problem". When completed, that study will allow BMSC to select the most reasonable and prudent solution and to determine how long the implementation of such remedy will take. Accordingly, BMSC suggests that the ROO be amended to require BMSC to:

1. Complete the engineering study within 60 days of the effective date of the Decision; and

2. Provide copies of the study to all other parties to the rate case, along with identification of the remedy selected and the estimated time to completion; and

3. Implement the selected remedy if no party objects within ten days of receiving the engineering information provided by BMSC, and, thereafter, to file notice that the "Boulders odor problem" has been remedied within 1 year of the effective date of the Decision. Or, in the alternative, if one or more parties timely objects to the selected remedy, to promptly seek Commission approval to implement the selected remedy

notwithstanding the objection of one or more of the parties to this docket.[3]

To be absolutely clear, the Company is not, in any way, seeking to avoid resolving the "Boulders odor problem" even though it does not entirely agree with the HOA and the Town over the nature and scope of the problem. Indeed, BMSC's voluntary implementation of a solution to the odor complaints concerning the CIE lift station reflects BMSC's commitment to addressing customer complaints. *See* ROO at 31-32. However, absent the modifications to the ROO suggested herein, BMSC submits that it will either be unable to ensure that the most prudent and reasonable solution to the "Boulders odor problem" is implemented, or, that it will face additional and potentially unnecessary Commission proceedings before such a remedy can be implemented. The suggested modifications are intended to minimize these potential obstacles to solving the "Boulders odor problem".

D. <u>Effective Date of New Rates</u>

The ROO adopts a proposal by Staff and the Company to terminate BMSC's hook-up fee and refund $833,367 to customers. ROO at 29. Under the ROO, BMSC is required to make the refund and obtain Staff's satisfaction that the refunds have been made before the rates can go into effect. ROO at 42, Ordering ¶ 2. Additionally, the Company must also obtain Staff's approval of the form of notice regarding new rates prior to the rates going into effect. *Id* at ordering ¶ 3. Because a Commission decision is not expected to be issued until sometime the week of November 27, 2006, the ROO would make it nearly impossible for rates to go into effect on December 1, 2006, the date when new rates are to be effective pursuant to A.A.C. R14-2-103.

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[3] BMSC has already approached the other parties regarding the proposed modification to the ROO discussed herein, however, the parties could not complete their discussions before the deadline for filing these Exceptions. BMSC will provide an update if the parties reach consensus.

BMSC accepts that refunds should be made before the new rates are effective and, as long as the Decision is issued at least two days before December 1, 2006, the Company expects to be able to make such refunds before that date. The Company requests, however, that the requirements to obtain Staff approval of the form of notice and Staff's satisfaction that refunds have been made not stay the effective date of the new rates. BMSC believes that Staff approval can be obtained after December 1, 2006, and that if Staff is dissatisfied with the making of refunds and/or the form of notice, Staff can file a notice in the docket and the Commission can then take action to freeze the rate increases and impose other remedies deemed appropriate. Otherwise, BMSC will be faced with a choice to either prorate billing for all customers for the month or to forgo a month of the additional revenues it is being authorized. Neither choice is necessary to protect the public interest in this case.

RESPECTFULLY SUBMITTED this 15th day of November, 2006.

FENNEMORE CRAIG, P.C.

By____________________________

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